CREATING VIRAL IMPACT IN BLACK COMMUNITIES THROUGH SMALL BUSINESS EXPANSION

Black-led CDFIs are well positioned across the nation to spark lasting wealth creation in Black Communities

EXPANDING BLACK BUSINESS CREDIT INITIATIVE

CREATING VIRAL IMPACT IN BLACK COMMUNITIES THROUGH SMALL BUSINESS EXPANSION

ACKNOWLEDGMENTS

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ABOUT THE EXPANDING BLACK BUSINESS CREDIT INITIATIVE (EBBC)

Formed in January 2016, EBBC is a Steering Committee comprising 11 practitioners, eight of whom are CEOs of CDFIs and most of whom are Black themselves and/or desire to see more capital directed to Black-owned businesses.

ABOUT THE AUTHOR

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- **Expanding Black Business Credit Initiative (EBBC) formed in January 2016**
- **Steering Committee of 11 practitioners (eight CDFI CEOs) with plans to expand**
- **Most are Black-led**
- **Purpose: To document and disseminate best practices in lending to Black businesses**
- **Goal: To dramatically increase lending to Black-owned businesses across the nation**
- **Idea: To build scale of success in lending to Black businesses by forming an investment and learning consortium ("the EBBC 7")**

REPORT CONCLUSION

The goal of this report is to highlight emerging opportunities to create wealth in under-served communities through small business expansion. The report develops a fresh way of looking at the economic requirements of low-wealth communities across the nation. We make the case that a comparison with the economic strategies employed in developing countries might inform the way we think about the investment and economic requirements of low-wealth communities in America. Second, we endeavor to highlight and better understand the hidden investment opportunities that exist in many low-wealth communities. Finally, we set forth the structure and framework of a credible investment proposal to unlock these hidden investment opportunities.

We establish in the report that if America wants to grow as a nation, it is in the nation's interest to address the broken economies of low-wealth communities. These low-wealth communities span across all races, ethnicities and regions of the country. As a result of scarce resources and a desire to break the problem into addressable/manageable segments, the Expanding Black Business Credit Initiative formed to make an argument to start with the Black community. We make it clear in this report that the potential investment gain for Black communities and the nation are highest because of multiple generations of oversight, under-investment and some intransigent racial perception issues. We believe that the structure and learnings from the EBBC initiative can be used for subsequent initiatives that address the problems of other low-wealth communities.

The report highlights the structure and framework of a specific investment initiative centered around a consortium of Black-led CDFIs which has both knowledge-sharing and capital raising components. For this consortium to be successful, significant support from large banks and foundations is required. Our hope is that this report will produce the funding necessary to achieve a successful pilot of the investment proposal, but moreover will create a series of other investment consortiums that address the specific requirements of the many other low-wealth populations of the country.

REPORT SALIENT POINTS

1. While small businesses can be very efficient creators of wealth in communities, it is also a fact in America that some communities have suffered from such sustained low wealth over decades — cumulative real wealth is so low — that it prevents the natural working of market forces and limits the formation of sustainable high-growth businesses. The two communities for whom this is most true — Blacks and Latinos — also happen to be the two communities projected to:
    a. be the largest proportion of America's most populous cities;
    b. be the largest proportion of the country's population by 2060;
    c. require an increasingly disproportionate amount of the country's social service spending.
2. If America wants to dramatically reduce the amount it spends on social services (a drag on growth), encourage more individuals from low-net-wealth communities to participate in the economy (a boost to growth), and provide a route to economic independence for these individuals, small business expansion within these communities is a very effective method.
3. The EBBC Initiative chose the Black community to begin with because the latent potential for success and returns are highest. This is the result of multiple generations of oversight and under-investment (similar to the history of economic development efforts in overseas developing countries such as Russia, Poland and Korea).
4. Many recent studies support the view that there are large hidden and untapped opportunities in the Black business community. There is also growing evidence of a bifurcation in the Black business community between younger, more highly educated Black business owners and those from previous generations who tended to set up businesses in lower-growth industries.
5. Many of these opportunities have historically been overlooked by investors and bankers because of generally held negative perceptions of Black businesses (low-growth industries, sub-scale and low business sophistication). Recent studies cited in this report show that, in areas such as net wealth and credit score, Black-owned businesses face significant hurdles when compared to White-owned firms, but — in many other categories — Black-owned firms have comparable attributes. If investors are to properly unlock the full investment potential of Black businesses, they will need to find lenders/banks that have track records at finding and growing small businesses.
6. CDFIs, while not perfect, are a very effective financial vehicle for lending to small businesses in a way that benefits the economies of low-wealth communities. However, if CDFIs are to be used for any large-scale wealth building initiative, we must dramatically increase the scale of high-performing organizations.
7. Market knowledge and intentionality are required to overcome the often-erroneous perceptions of Black businesses. The consortium looked at both demand and supply issues regarding Black businesses and determined that the largest constraint was on the supply side. CDFIs that are successful at lending to Black businesses in their respective markets across the country are simply too small in comparison to the size of the credit gap and the advisory needs of borrowers.
8. In low-wealth areas, CDFI products and services are in high demand. However, particularly in Black low-wealth neighborhoods, the credit gap far exceeds the capacity of CDFIs (bank and non-bank). Large banks could play a much larger role if they better understood the role of CDFIs as mature, agile and innovative lenders on the front line in low-wealth areas.
9. Dramatic increases in lending to Black businesses could be possible with an increase in the scale of capital availability bolstered by knowledge-sharing. There are several models of investment consortiums that combine capital raising and peer exchange to significantly enhance the size and speed of impact.
10. The "viral" outcome envisioned by the EBBC consortium is multi-faceted. The CDFIs that make up the EBBC-7 consortium employ the same tools all CDFIs use when lending to hard-to-finance businesses in underserved low-wealth communities, but these seven have used those tools to successfully and intentionally lend to Black businesses in their respective markets. The goal of the consortium will be to document, enhance and disseminate the "soft" and "hard" inputs used in their lending.

EXPANDING BLACK BUSINESS CREDIT INITIATIVE

OVERVIEW OF EBBC INVESTMENT PROPOSAL

"Achieving scale at the capital supply level is an important ingredient to creating small business expansion and ultimately a viral (multiplier) impact in Black communities across the nation."

A well-planned, targeted and strategic equity investment[1] in Black-led CDFIs has the potential to highlight overlooked opportunities which could have the dual benefits of delivering returns to investors and increasing wealth in Black communities. Moreover, if the investments and success are large enough, then other intentional mainstream investors may get involved, leading to a cycle of success for both investors and low-wealth Black communities. Achieving scale at the capital supply level is an important ingredient to creating small business expansion and ultimately a viral (multiplier) impact in Black communities across the nation.

This is the vision of a group called the Expanding Black Business Credit (EBBC) consortium. Formed in January 2016, EBBC is a Steering Committee comprising 11 practitioners, eight of whom are CEOs of CDFIs and most of whom are Black themselves and/or desire to see more capital directed to Black-owned businesses. Seven of the CDFIs on the Steering Committee provided data for this report; they are referred to as the EBBC-7 hereafter.

A series of meetings of the EBBC Steering Committee over the course of 2016 illustrated the fact that dramatic increases in lending to Black businesses could be possible with an increase in the scale of capital, bolstered by knowledge-sharing. **There are several models of investment consortiums, but few successfully combine capital raising and peer exchange to significantly enhance the size and speed of impact.**

The goal in forming the EBBC consortium was to learn from other initiatives in this country and abroad to understand best practice for an initiative that strives to build scale, visibility, impact and returns to investors.

The Boston-based Housing Partnership Network (HPN) is an excellent example of a peer learning platform that has successfully combined capital-raising and knowledge exchange to create impact. Launched in the early 1990s as a non-profit organization, HPN began as a pure peer learning group of CEOs of intermediaries providing technical assistance to CDCs doing affordable housing across the nation; later, development companies and loan funds joined.

After ten years, as they discovered similar problems and opportunities, network members moved beyond being a peer network to solving problems together. In 2001, they raised money for a loan fund owned by an affiliate of the Housing Partnership Network; next, they undertook a HUD contract jointly. They later created HP Insurance Exchange, a REIT, a charter school financing vehicle and other entities. Today there are 97 member organizations, 10 social enterprises, and a 50+ person staff. CEOs meet semi-annually as do CFOs, risk managers, and other common functional managers. The peer learning and capital raising capabilities of the group far exceed what could have been achieved independently by members.

The key to the success of HPN's peer learning groups is that they are controlled by member CEOs. These CEOs, in turn, over time develop a level of camaraderie and trust that leads to greater sharing and knowledge exchange. Once there is a sufficient level of understanding and trust, the group raises capital for a common purpose by forming jointly controlled financial cooperatives as this structure makes the businesses very focused on member needs.

The EBBC consortium recommends borrowing substantially from the HPN peer learning model as a way to set up a capital vehicle and peer learning mechanics. At right the chart summarizes a potential EBBC company structure and product outline.

EBBC Company and Fund Structure

FOCUS

- Black-owned employer firms with 5+ employees and revenues >$1 million
- Aim to deliver substantial increases in capital to urban and rural Black-owned small businesses
- Continuous learning/innovation of product through tightly integrated peer network

INVESTORS

- Bank CRA
- Foundations
- Family offices
- Fund-of-funds
- High net worth individuals

EBBC EQUITY FUND (CDFI Equity Loan Fund)

MEMBERSHIP

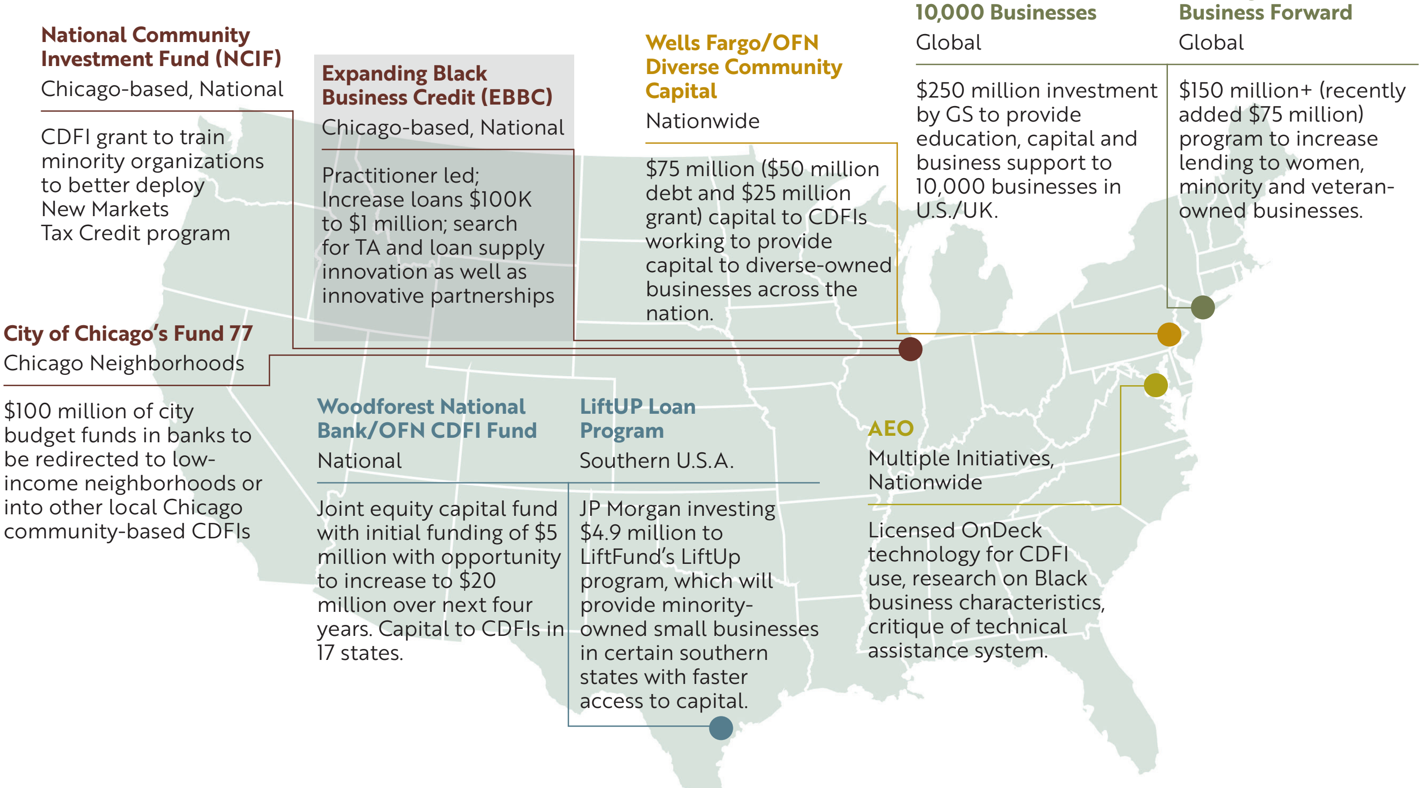
- 7-10 CDFIs from U.S. regions with highest concentration of Black businesses
- All financially sound with long track records of success
- Part of a tightly integrated peer learning group

RETURN PROFILE

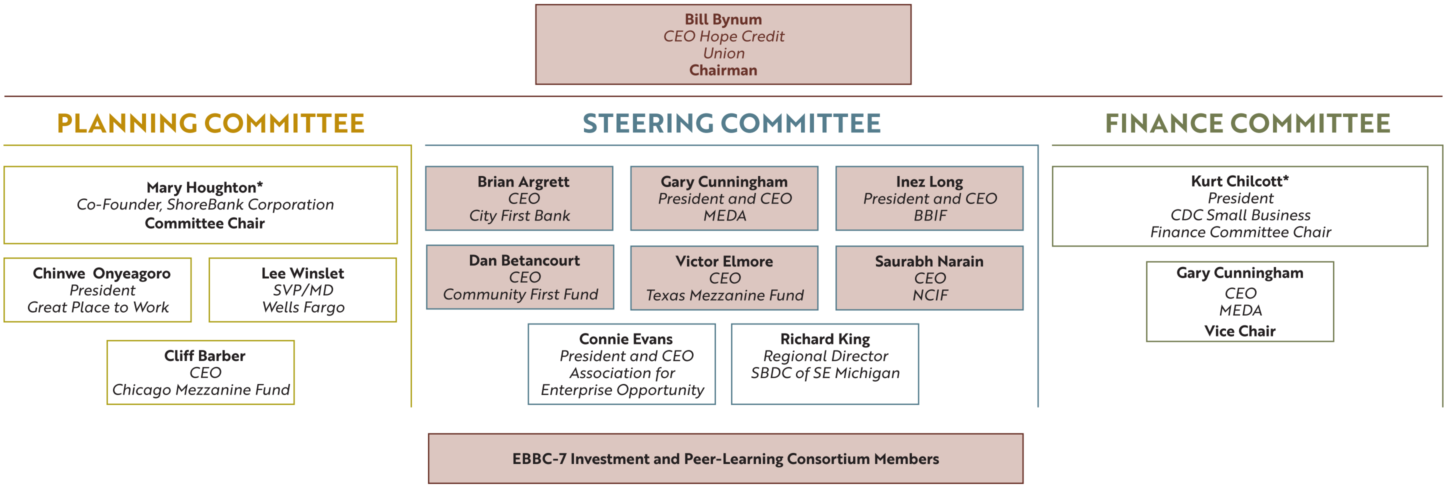
- Capital preservation
- Impact returns
  - job creation and retention
  - business expansion

While the proposed EBBC structure, discipline and strategy are unique, other past and existing initiatives have been and are trying to increase wealth in low-wealth areas regardless of racial or ethnic make-up. Below is a landscape view of other initiatives aimed at increasing credit to low-wealth Black communities. Most of these programs are aimed at delivering additional capital to CDFIs. In every case, these essential efforts are having significant impact. However, they are not focused on building significant scale at the supply level and may not have the desired viral impact of the EBBC initiative.

Landscape of Other Related Initiatives



EBBC Organization



*Planning and Finance Committee Chairs are members of the Steering Committee

Some aspects of the scale-building model the EBBC-7 aspires to were present in a recent investment by J.P. Morgan Chase in the Valley Economic Development Corporation (VEDC). In this model, Chase invested $3 million in VEDC, which operates CDFI loan funds in key cities across the nation with high concentrations of Black businesses.

This $3 million was seed money to attract other similarly minded investors to create a pool of capital 10 times in size or $30 million. This is a good idea, but it relied on a single CDFI business model (VEDC), which has strong central control, and satellite funds across the nation with limited autonomy. Also, the initiative was primarily focused on urban areas with very little attention given to rural Black-owned small businesses.

Finally, as will be discussed further in the report, wealth building initiatives need to focus on one low-wealth community at a time. Many of the initiatives in the preceding U.S. map are targeted at many different low-wealth communities, which is helpful but dilutes success in any one community and further limits the chance for a "viral" outcome.

The "viral" outcome envisioned by the EBBC consortium is multifaceted. The chart below illustrates the process of how peer learning and capital will combine to produce impact outputs along several dimensions. The seven CDFIs that make up the EBBC-7 consortium employ the tools that all CDFIs use when lending to hard-to-finance businesses in underserved low-wealth communities, but these seven have used those tools to successfully and intentionally lend to Black businesses in their respective markets. The goal of the consortium will be to document, enhance and disseminate the "soft" and "hard" inputs used in their lending processes. In the first instance, the consortium will want to ensure that best practice is maximized across the seven members for maximum benefit, but a viral outcome will only be achieved when the group's market-tested best practice is spread to other intentional investors, whether they be banks or unregulated CDFIs. Of course, a primary goal of the initiative is to increase originations to Black-owned businesses by encouraging cross-fertilization of best practice techniques. However, impact will also be measured along non-lending dimensions such as job creation, the financial health of the small business and its owner.

EBBC Consortium Black Business Lending Production Function

“SOFT” INPUTS

(Qualitative, gut-based, judgment aspects of lending Black businesses)

Market Segmentation
(Cultural knowledge/Focus)

- Collateral type
- Geography
- Ethnicity
- Generation of business owner
- Business size

“HARD” INPUTS

(Creative and collaborative use of hard inputs into underwriting process)

Underwriting and TA*
(Intellectual property)

- Portfolio balancing
- Capital stacking
- Loan processing
- Impact assessment
- Credit enhancement
- Pre-loan TA
- Post-loan services
- Cross subsidy

IMPACT OUTPUTS

(Unique range of impact outputs related to Black businesses and areas)

Loan Performance Metrics
(Quantifiable impact)

- Originations
- Net charge-off rate
- SME Financial Health Improvement
- Owner Financial Health Improvement
- Job creation
- Community stability

*Underwriting and TA inputs would be standardized and wrapped up into a defined risk spectrum (i.e., B2 – C3 rated loans)

ANALYSIS AND EVIDENCE TO SUPPORT INVESTMENT PROPOSAL

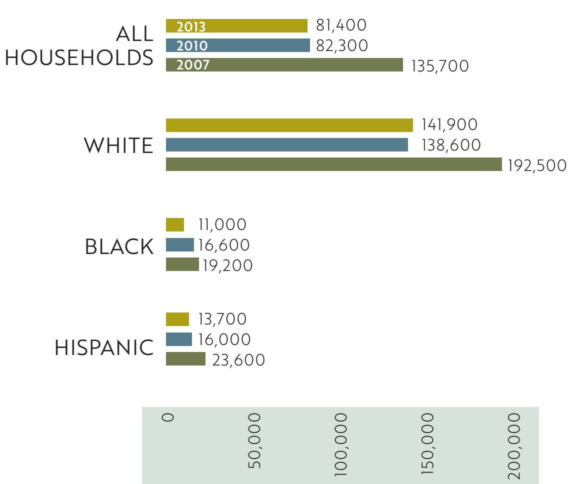
> *"The wealth created by small businesses is particularly important because it is a measure of a community's economic resilience and dynamism."*

It is widely accepted by economists that small business growth and formation is critical to increasing wealth in nations, regions and communities.[2] In fact, many studies have shown that the most efficient way to increase wealth in a community is to support entrepreneurship.[3] The wealth created by small businesses is particularly important because it is a measure of a community's economic resilience and dynamism. This wealth increases a community's ability to form new businesses, innovate and take risks. Moreover, wealth and small business formation are often primary indicators of whether market forces are working properly in a community. Without adequate wealth – and particularly intergenerational wealth - communities stagnate, economic prospects diminish and social ills proliferate.[4]

While small businesses can be very efficient creators of wealth in communities, it is also a fact in America that some communities have suffered from such sustained low wealth over decades – cumulative real wealth is so low - that it prevents the natural working of market forces and limits the formation of sustainable high-growth businesses.[5] The two communities for whom this is most true – Blacks and Latinos[6] – also happen to be the two communities who are projected to:

- be the largest proportion of America's most populous cities;
- be the largest proportion of the country's population by 2060;
- require an increasingly disproportionate amount of the country's social service spending.[7]

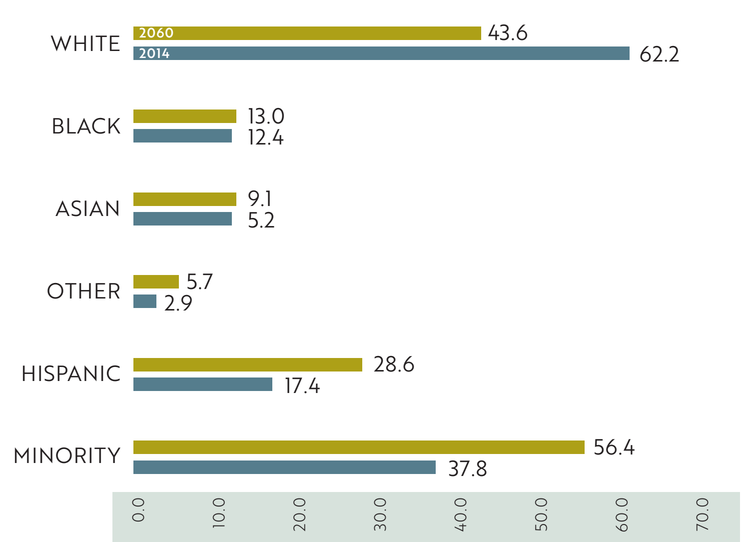
Wealth by Race and Ethnicity, 2007-2013



Source: Pew Research

Note: Blacks and Whites include only non-Hispanics. Hispanics are of any race.

Distribution of the Population by Race and Ethnicity, 2014 and 2060



Source: U.S. Census Bureau, 2014 National Projection

If America wants to dramatically reduce the amount it spends on social services (a drag on growth), encourage more individuals from low net wealth communities to participate in the economy (a boost to growth), and provide a route to economic independence for these individuals, one of the most effective methods is through small business expansion within these communities.

The potential benefits to the nation's economy could be very large indeed given the decades-long suppression of market forces in both the Black and Latino communities. There are international examples of economic regions where market forces were limited and company formation was lacking. In these economies, once there was sufficient investment (capital availability) in small businesses, economic growth was outsized and the benefits to the nation, its communities and investors were large.[8]

In many countries (Russia, Korea, Bangladesh and Poland to pick a few examples) market forces and wealth accumulation were suppressed or non-existent for decades, but through sustained and focused investment in growing small businesses and entrepreneurship these economies exhibited, in many cases, double-digit economic growth and became darlings of investors around the world.

In America, a properly formed, market-based investment in low-wealth communities, where market forces have been suppressed for decades, has the potential to deliver similar outsized returns[9] to investors if efforts are intentional, focused, large, visible and use the right capital delivery vehicles.

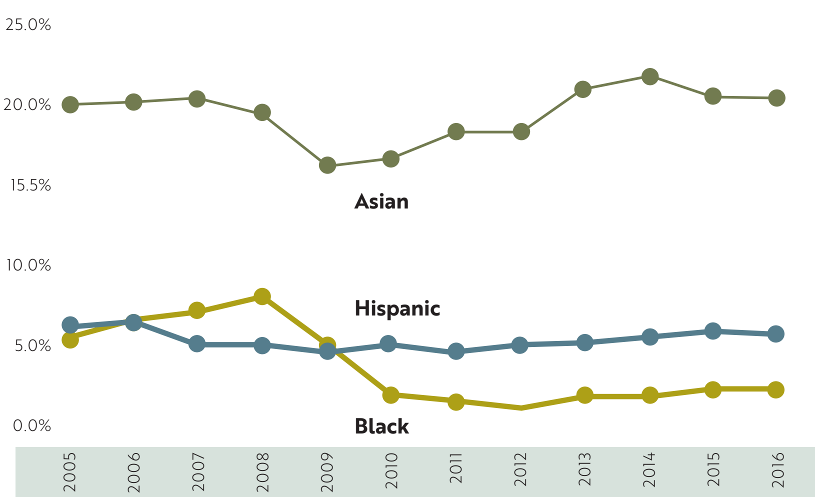
THE BLACK COMMUNITY IS THE TARGET OF THE EBBC INITIATIVE

"The latent potential for success and returns are highest in the Black community because of multiple generations of oversight and underinvestment."

The two communities with the lowest net wealth in the country are the same that will grow the most in the coming decades in terms of proportion of the American population – Blacks and Latinos. There are other populations who aren't at the bottom of the league table for net wealth (Asian and Native) but for whom further small business investment could also benefit immensely. However, just as developing countries had to pick industries to focus on to kick-start growth, initiatives should focus on one low-wealth community at a time to be successful, because the nature and business characteristics of each community can be vastly different. Also, after launching a pilot within one community there will be lessons that enhance the setup and structure of future initiatives in other communities. Therefore, the nature of any investment initiative should be tailored to the specific needs of each target population.

A strong argument can be made to pilot a small business investment initiative in any of the low-wealth communities discussed, but EBBC proposes to start with the Black community, which was hardest hit by the Great Recession. The latent potential for success and returns are highest because of multiple generations of oversight and underinvestment (similar to the history of efforts in Bangladesh, Poland and Korea). Evidence of the damage (and potential opportunity) is best illustrated in the chart below, which shows the trickle of capital which is flowing to Black businesses at present. It is often in areas where animal spirits[10] and market forces have been suppressed for the longest, where gains to the economy and investors are highest.

Percent of total SBA 7(a) loan guarantees by race and ethnicity 2005-2016



Many recent studies support the view that there are large hidden and untapped opportunities in the Black business community. William Bradford, a professor of Economics and Finance at University of Washington's Foster School of Business, found that entrepreneurship shows great potential for increasing wealth in the Black community when compared with other low-wealth groups.[11] A recent study by the Association for Enterprise Opportunity (AEO) concluded that if Black businesses were given the capital and support required, they could create 600,000 jobs nationally equating to a reduction in the current national Black unemployment rate from 7.9% to roughly 5%. These results were based on modest assumptions of employment uptake by both microenterprises and larger employer firms.[1]

There is also growing evidence of a bifurcation in the Black business community between younger, more highly educated Black business owners and those from previous generations who tended to set up business in lower growth industries. According to a recent report by FIELD, a program of the Aspen Institute, "there is an emerging class of minority entrepreneurs who have started firms and, in some instances, may be bringing a stronger skill set to their venture."[13] This points to the emergence of Black-owned businesses which are in higher growth industries that can produce higher profits and growth for investors. Because this emerging group of Black entrepreneurs is smaller and there is a general perception that Black businesses are in low-growth, high-risk industries, investors and banks may be overlooking this emerging and potentially highly profitable customer segment.

The size of the opportunity in the Black community is also illustrated in census data, which shows that Black businesses occupy a large and important footprint in the American business landscape. There are 2.58 million Black-owned businesses, which represent just over 9% of all firms in the U.S.[14] These firms generate $150 billion in revenue, supporting 3.56 million jobs.[15] Black businesses are the fastest growing segment of the nation's small business owners. Black business ownership increased 38% between 2008 and 2012, a significant achievement in the wake of the Great Recession.[16] In spite of these very impressive statistics, the number of employer firms is 4% of the total, which is reflective of the trend pointed out earlier where multi-generational low wealth and suppressed market forces have led to limited formation of higher-growth small business enterprises. Still, these figures and the potential impact figures quoted above illustrate the opportunities that exist in this community if more capital were available to these companies.

The goal of any small business initiative would be to prove success by – at least initially – focusing on businesses that exhibit high growth and high employment potential, thereby encouraging further capital and fostering entrepreneurialism in these communities. Any successful small business initiative for Black businesses needs to focus on employer firms that have more than five employees and revenues of more than $1 million. These firms are large enough and mature enough to achieve meaningful growth and hire employees in larger numbers.

PERSISTENT NEGATIVE PERCEPTIONS OF BLACK BUSINESSES MUST BE OVERCOME

"Delving below the uniform perceptions to find opportunity is not easy and requires a great deal of market knowledge, lending experience, creativity, judgment and intentionality."

As we have seen so far, there are many hidden and untapped opportunities within the Black business community. However, many of these opportunities have historically been overlooked by investors and bankers because of generally held negative perceptions of Black businesses (low growth industries, sub-scale and low business sophistication). These negative labels have been applied uniformly across all Black businesses when, in fact, there is great diversity among Black businesses, just as in any other group.

Analysis by Alicia Robb of data from the Kauffman Firm Survey shows that, in areas such as net wealth and credit score, Black-owned businesses face significant hurdles when compared to White-owned firms, but in many other categories, Black-owned firms have comparable attributes.[17] The chart below shows areas of difference (shaded) and areas of commonality.[18] Given the negative perceptions associated with Black businesses, it is interesting to note the number of areas where Black-owned firms have characteristics similar to those of White-owned firms. Areas of commonality such as obtainment of a post-graduate degree, previous years of industry experience and possession of intellectual property further reinforce the earlier point about the emergence of a new, more highly educated Black business segment that is starting businesses with higher potential return profiles.

Delving below the uniform perceptions to find opportunity is not easy and requires a great deal of market knowledge, lending experience, creativity, judgment and intentionality. If investors are to properly unlock the full investment potential of Black businesses, they will need to find lenders/banks who have track records at finding growing small businesses. However, in a post financial crisis world, the natural order of who can most effectively lend to small businesses - particularly those in low-wealth communities - has been turned on its head.

Firm and Owner Characteristics of Kauffman Firm Survey Businesses

	White	Black/Hispanic	Variance
Net wealth of $250K + (2008)	45.40%	20.60%	-24.80%
High credit score	13.70%	7.20%	-6.50%
Previous start-up experience	44.30%	38.10%	-6.20%
Incorporated	57.10%	51.10%	-6.00%
Some college	36.30%	43.20%	6.90%
Low credit score	30.10%	39.50%	9.40%
College degree	32.70%	27.70%	-5.00%
Team ownership	31.60%	26.80%	-4.80%
Medium credit score	56.10%	52.80%	-3.30%
Owner age	45.80%	42.80%	-3.00%
Graduate degree+	18.20%	15.70%	-2.50%
Previous years of industry experience	12.80%	11.60%	-1.20%
Intellectual property	19.90%	19.80%	-0.10%
Home based	50.90%	51.60%	0.70%
Average hours worked	42.70%	43.50%	0.80%
Product offerings	51.20%	52.10%	0.90%

Source: Alicia Robb, Access to Capital among Young Firms, Minority Firms, Women-owned Firms and High Tech Firms (Washington, DC: Small Business Administration, April 2013), page 11.

SOLUTION: COLLABORATIVE PARTNERSHIPS BETWEEN CDFIS AND BANKS

"A mutually beneficial co-dependency between large banks and CDFIs has developed with CDFIs lending to harder-to-finance businesses and large banks providing capital to customers with stronger collateral and credit profiles."

Community Development Financial Institutions (CDFIs) are an emerging vehicle of choice for lending to small businesses in low-wealth communities. Because they exist with a social mission focus, CDFIs can often allocate more time to preparation of loan proposals and provide a more customized lending solution than conventional lenders. To provide additional layers of risk protection, CDFIs have been creative in using innovative capital stacks and collaborative lending arrangements. Finally, CDFIs are particularly adept at bringing multiple resources together to ensure the success of a loan. These resources include, but are not limited to, business services, but may also include creative monitoring systems to catch problems before they grow.

Of course, even as CDFIs have shown their effectiveness at lending to small businesses in low-wealth areas, it is still the case that the vast majority of loans to small businesses come from the regulated banking sector. CDFIs are constantly innovating on a deal-by-deal basis. This agility and flexibility is what, in fact, makes them most effective as front line lenders in low-wealth areas with harder to finance businesses. One deal might be a straightforward senior loan with strong collateral. Another deal may be a "side-by-side" deal with a larger bank as co-lender with the CDFI taking the riskier slice. Or a deal may require the CDFI to take a junior position behind a large bank and also provide some early business service intervention to increase cash flow. One of the advantages of using CDFIs when lending in low-wealth areas is that they are motivated to find the tools to manage risk at whatever position they find themselves in vis-à-vis other lenders or the borrower.

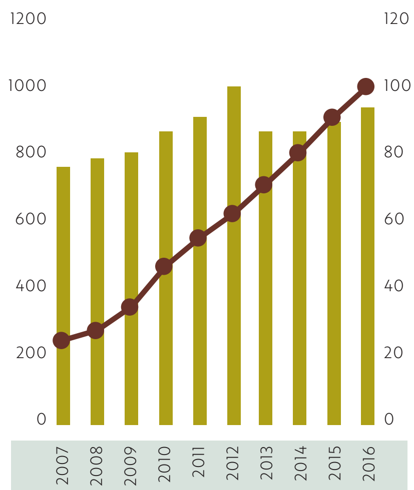
It is therefore not surprising that, in low-wealth areas CDFI products and services are in very high demand. However, particularly in Black and Hispanic low-wealth areas, the credit gap far exceeds the capacity of CDFIs (bank and non-bank) trying to meet the need. It is in this area of capital provision that large banks could play a much larger role especially if they understand that CDFIs are mature, agile and innovative lenders on the front line in low-wealth areas. They are lending to businesses large banks cannot afford to finance.

A mutually beneficial co-dependency between large banks and CDFIs has developed with CDFIs lending to harder-to-finance businesses and large banks providing capital to customers with stronger collateral and credit profiles. Large banks often need a place to refer a customer until it can again fit within the bank's risk parameters – and CDFIs, with limited capital, are often happy to shift their stronger clients up to larger banks, thereby freeing capital to hunt for new customers that fit into the CDFI's mission. This symbiotic relationship between large banks and CDFIs has worked well to date, but it could work better for both parties.

Large banks could form closer business partnerships with CDFIs. As we have seen, CDFIs often play the role of being the "front door" for harder-to-finance businesses. As these businesses mature, they become new business candidates for large banks. Large banks could look for ways to formalize this process by compensating CDFIs to proactively present suitable new business clients and joint financing opportunities. Such an arrangement would serve the dual purpose of providing large banks with a credible source of new business while giving CDFIs an economically viable way to better manage their loan portfolios.

First introduced in the 1980s, the CDFI industry began to take shape and grow just as consolidation of the mainstream banking industry began to take effect. The CDFI industry has grown from assets of $5 billion in 1995 (just before the repeal of Glass-Steagall) to around $100 billion in assets in 2016.[19] CDFIs have moved from their nascent stage, through an initial growth stage and are now set to become larger more mature lenders to small businesses, particularly those in low-wealth communities.

The CDFI Industry Has Grown in Number and Assets...



Source: Social Investment Forum, 2012 Report on Social Investing Trends in the United States, 2015 data from FDIC, NCUA and Trade Associations

And Is Now Entering a New Phase of Maturity and Sophistication

Attributes of Each Stage

PROOF OF CONCEPT

- Diversity of Mission and busters: individuals, religious, foundations, civic
- Limited balance sheet leverage
- Market a product exploration

Crisis: *Legitimacy*

Challenge: ***Basic lending systems***

STEADY GROWTH

- Public capital through CDFI Fund/NMTC
- Banks become more dominant source of leverage
- Stronger product and process standardization
- Prototyping of boutique strategies and structured finance tools

Crisis: *Diversification*

Challenge: ***New investor structures***

CAPITAL TRANSFORMATION

- Capital market recognition (e.g. S&P rated CDFIs)
- Balance sheet Security to investors in exchange for long-term capital
- Convergence with social impact investors
- Emergence of Tech CDFIs
- Growth of CDFI depository sector

Crisis: *Identity*

Challenge: ***Risk management & technology***

Source: Opportunity Finance Network, CDFI Futures: An Industry at a Crossroads, March 2016

However, for all its growth and success over the past 20 years, the CDFI industry is still an infant industry that is sub-scale in comparison to the size of the credit gap in many low-wealth communities. Moreover, the industry is highly fragmented partly because one of the competitive advantages of these institutions is the depth of their local small business and community knowledge. Therefore, while CDFIs have deep community knowledge and more flexibility in lending, their success is highly dependent on continued links with banks.

CDFIs, while not perfect, are a very effective financial vehicle for lending to small businesses in a way that benefits the economies of low-wealth communities. However, if CDFIs are to be used for any large-scale wealth building exercise as contemplated in this paper, efforts will need to be made to dramatically increase the scale of high-performing organizations.

BLACK-LED CDFIS ARE WELL POSITIONED TO SPARK VISIBLE INITIAL SUCCESS

"While these Black-led CDFIs have been adept at lending to Black businesses in their respective markets, their ability to scale has been limited."

While it is the case that CDFIs have been effective lending to small businesses in a way that benefits low-wealth communities, CDFIs that have shown success lending in the Black community have remained too small-scale to have visible impact. This is partly because many of the CDFIs that have been most successful at lending to Black businesses are Black-led small businesses themselves and so suffer from some of the same negative perceptions when they try to raise capital.

As was noted earlier, CDFIs are emerging as the vehicle of choice for lending in low-wealth communities, but even for these CDFIs, a special amount of market knowledge and intentionality is required to overcome the often erroneous perceptions that have developed around Black businesses. While there are many well-intentioned and successful institutions that lend to Black businesses all around the country, we have found that Black-led CDFIs are particularly adept at seeing past negative perceptions to understand and unearth hidden value. Recognizing this fact, a group of practitioners formed the Expanding Black Business Credit (EBBC) consortium in January of 2016.

At the time of launch, the aim of the consortium was to explore innovative ways to dramatically increase credit to growing businesses that benefit low-wealth Black communities. There was an initial focus on how to deliver more credit to Black-owned businesses that could, in turn, drive employment in these communities. As stated earlier, the initial working hypothesis was that opportunities for growth seemed highest in the Black community given years of oversight and suppressed market forces. This hypothesis seemed to be supported by data, which shows that the credit gap in the U.S. Black business community is estimated to be between $7 and $8.5 billion, the highest in the nation on a population-adjusted basis.[20] The consortium looked at both demand and supply issues regarding Black businesses and determined that the largest constraint was on the supply side. CDFIs that are successful at lending to Black businesses in their respective markets across the country are simply too small in comparison to the size of the credit gap and the advisory needs of borrowers.

Over the course of six months in 2016 the EBBC consortium conducted in-person site visits and collected extensive performance data on seven CDFI lending/investing firms in markets with a preponderance of Black businesses.[21] The data collected was compiled by Aeris, a nationally-recognized CDFI ratings agency. The qualitative and quantitative data collected showed that the seven CDFIs have $630 million in combined total assets. The six organizations that lend directly to Black-owned businesses originated $20 million in loans to Black-owned businesses in fiscal year 2015.

Lending to Black-owned businesses is sometimes more time-consuming but the lending organizations are financially sound, have deep knowledge of what it takes to lend to Black businesses and have ample room to grow.

The comparison with peers was limited to three of the seven organizations, the non-profit small business loan funds that report to and could be compared to similar asset-size non-profit small business loan funds which report to the Opportunity Finance Network. As a group, 37% of the EBBC organization's loans outstanding were to Black businesses and they have an average charge-off rate of 1.6%, just 10 basis points higher than the 1.5% reported as their peer group industry average.

As the chart below illustrates, the EBBC-3 are more highly leveraged but otherwise similar to their peer group. They maintain loan loss reserves of over 5%, which is very healthy albeit lower than their peer group, and had a slightly higher over-90-day delinquency rate. In FY15, 41% of this group's originations were to Black-owned businesses.

EBBC-3 Cohort Performance vs. Peer Group

	EBBC-3 Cohort (N=3)	OFN Peer Group B3 (Assets $10-21m) (N=18)
CAPITALIZATION		
Equity	26%	49%
Borrowed Capital	74%	51%
FINANCING ACTIVITIES AND PERFORMANCE		
Net Charge-off Ratio %	1.6%	1.5%
Delinquencies, 90 days	4.6%	3.6%
Loan loss reserve ratio	5.5%	8.3%
Self-sufficiency Ratio (earned revenue/Expenses)	60%	59%
BLACK BUSINESS LENDING PERFORMANCE		
Average loans outstanding to Black-owned Businesses	$3,222,000	NA
Average loan originations in last FY to Black-owned firms	$1,621,000	NA
% of originations to Black-owned Businesses	41%	NA

Source: EBBC analysis
*EBBC-3 Cohort is non-profit consortium members with Assets ranging from $7-35 million

CDFI Methodologies Applied by Black-led Small Business CDFIs

- Provide **higher and lower risk that products** with a multi-unit structure; or partner routinely with banks to find deals.
- Use combined **impact/credit scoring** to give preference to Black-owned businesses.
- **Simplified lines of business and products** to afford time needed for flexible structuring and loan servicing.
- **Manage New Markets Tax Credits,** which can reduce of subsidy needs.
- Offer both **debt and advisory services** as co-equal inputs, either intentionally integrated or through external advisory partner organizations.
- Maintain **cultural focus** on Black-owned businesses in mission, goals, hiring and office location.
- **Innovative use of technology** to increase reach, efficiency and scalability.

The same data was compiled on four other members of the consortium, but there is no peer group analysis possible since this data came from one commercial bank, one credit union and its non-profit affiliate, one mezzanine fund and one fund management company. However, the following information is relevant.

- Both of the regulated institutions had parent non-profit higher-risk loan funds that receive grant funding;
- The three lending organizations originated $15 million in loans to Black-owned firms, 25% of their total annual originations. The net charge-offs of the two regulated institutions were under 40 basis points while the mezzanine fund, a higher risk business, had higher losses but booked a healthy profit.

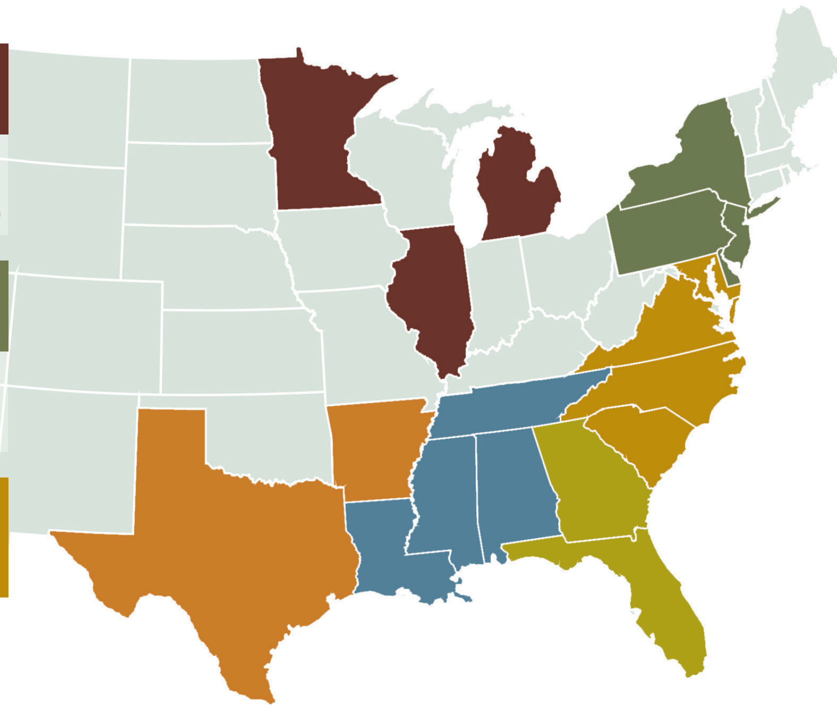
The fourth organization makes equity investments, primarily in Black-owned banks; six banks originated $41 million in loans to minority-owned businesses in FY 2015.

Thus, the EBBC-7 can lend to Black businesses successfully and remain financially sound by adhering to a strict set of fiscal/risk management best practices. However, there are also several qualitative aspects of their lending practices, which make them successful at lending to Black businesses. The chart below enumerates tools used successfully at the seven institutions studied.

Many of these methodologies can make any CDFI successful, but we found that it was the way in which each consortium member deployed these different CDFI "tools" that made the difference. For example, at one CDFI, Technical Assistance (TA) is cost-effectively integrated into the lending model to produce a dual benefit by requiring a monthly roundtable format. In this arrangement, every borrower must attend a borrower meeting either in person or by Skype. The meeting is beneficial to the borrower because it allows cross-learning among similar businesses, but it is equally beneficial to the CDFI because all in attendance must bring along (or pre-submit) their monthly loan payments or be in default of their loan. This allows the CDFI to identify and solve problems before they become bigger, but it also keeps its delinquency and charge-off rates relatively low given the type of businesses it is financing.

While these predominantly Black-led CDFIs have been adept at lending to Black businesses in their respective markets, their ability to scale has been limited. Our research and due diligence showed that each of these organizations has credible plans to grow their lending to Black businesses in their respective markets. With additional equity and more aggressive leveraging, they would have solid capacity to accept debt to support these growth plans.

EBBC-3 Cohort Performance vs. Peer Group



Region 1
(Illinois, Michigan, Minnesota)
CDFI#1 and CDFI#2

% Loans outstanding to Black-owned = 45%
Net charge-off rate = 1.00%
Number of Black businesses = 270,323 (10%)

Region 2
(Pennsylvania, New York, New Jersey)
CDFI#3

% Loans outstanding to Black-owned = 14%
Net charge-off rate = 0.80%
Number of Black businesses = 339,247 (13%)

Region 3
(Washington, DC, Maryland, North Carolina, South Carolina, Virginia)
CDFI#4

% Loans outstanding to Black-owned = 57%
Net charge-off rate = 0.36%
Number of Black businesses = 228,990 (9%)

Region 4
(Florida, Georgia)
CDFI#5

% Loans outstanding to Black-owned = 53%
Net charge-off rate = 3.00%
Number of Black businesses = 508,185 (20%)

Region 5
(Mississippi, Alabama, Louisiana, Tennessee)
CDFI#6

% Loans outstanding to Black-owned = 19%
Net charge-off rate = 0.30%
Number of Black businesses = 306,868 (12%)

Region 6
(Texas, Arkansas)
CDFI#7

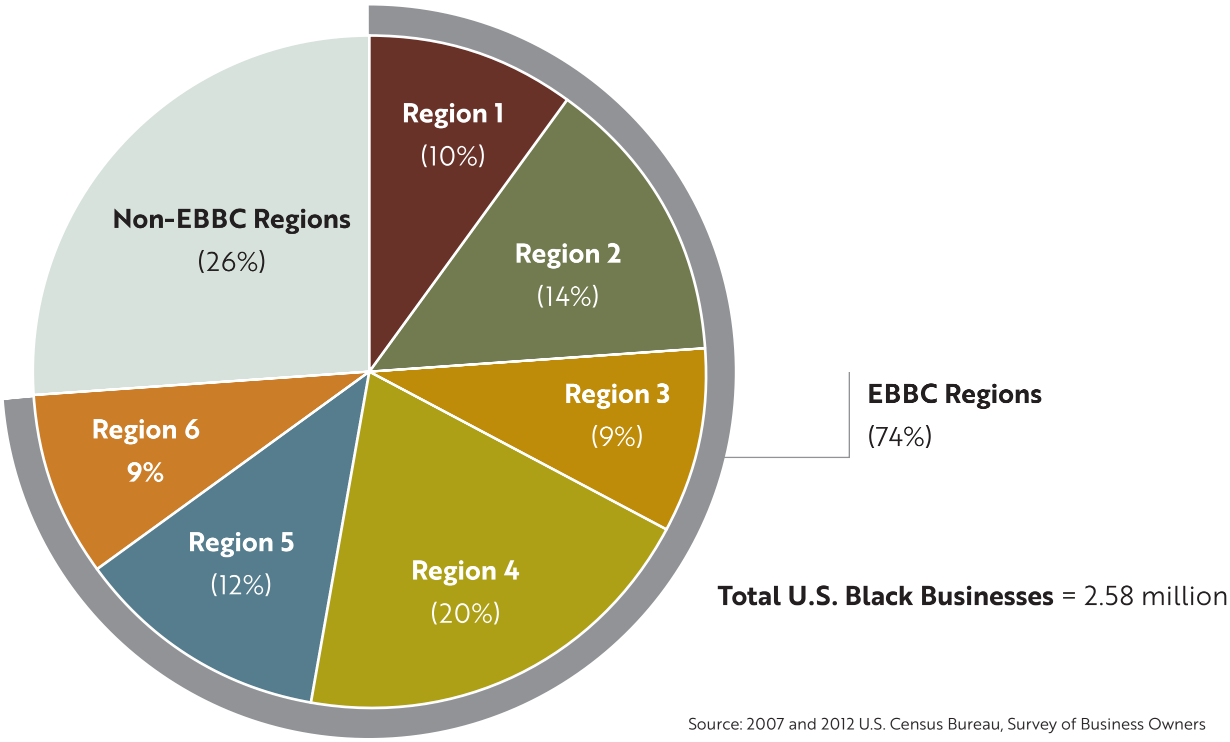
% Loans outstanding to Black-owned = 38%
Net charge-off rate = 2.96%
Number of Black businesses = 237,257 (9%)

"The goal of the initiative is to use these initial seven CDFIs as a 'beach head' in each region, proving success and encouraging others to follow the lead."

The map above illustrates the regions in which the EBBC-7 operate and the size of the opportunity in each region. As mentioned earlier, the goal of any investment initiative would be to demonstrate growth and returns in the addressable markets of each member of the EBBC-7, but more importantly to make that success visible enough that it would encourage other intentional lenders to seek similar returns, thereby creating a viral effect. For example, in Region 1, which includes the states of Illinois, Michigan and Minnesota, there are two EBBC-7 CDFIs represented. These CDFIs have combined 40 years' experience lending and investing in low-wealth areas. Region 1 includes Cook County, Illinois, the county with the single highest concentration of Black businesses in the nation equaling 100,155 businesses in total. Cook County is also home to Chicago, America's third largest city by total population. Overall, Region 1 has 270,323 Black businesses, representing 10% of all the Black businesses in the nation.

Each of the EBBC-7 regions exhibits similar success and growth characteristics, but has different rural/urban mixes. For example, Region 5, which includes Mississippi, Alabama, Louisiana, and Tennessee, has 12% of the nation's Black businesses, but the businesses tend to be more rural-based. Region 2 and 4 have a balance between rural and urban businesses. In designing the make-up of the EBBC-7 we intentionally recruited a mixture of rural and urban-based CDFIs.

EBBC-7 Region Coverage % Total U.S. Black Businesses



Source: 2007 and 2012 U.S. Census Bureau, Survey of Business Owners

"The region covered by the EBBC-7 has the potential to touch over 74% of the nation's Black businesses."

This chart shows that the region covered by the EBBC-7 has the potential to touch over 74% of the nation's Black businesses. The map on the preceding page shows the location of the EBBC-7 within each region. The goal of the initiative is to use these initial seven CDFIs as a beachhead in each region, proving success and encouraging others to follow. Success will come through careful scaling of each organization, but the real success of the program will come with successful communication of outcomes to a broad audience of other lenders in each region. Bi-annual "road shows" to illustrate success, spread best practices and encourage cross-learning is the key to giving this effort a viral effect.

CONCLUSION

The aim of this report was three-fold. First, the report develops a fresh way of looking at the economic requirements of low-wealth communities across the nation. We posited that a comparison with the economic strategies employed in developing countries might inform the way we think about the investment and economic requirements of low-wealth communities in America. Second, we endeavored to highlight and better understand the hidden investment opportunities that exist in many low-wealth communities. Finally, we set forth the structure and framework of a credible investment proposal to unlock these hidden investment opportunities.

As we established in the report, if America wants to grow as a nation, it is in the nation's interest to address the broken economies of low-wealth communities. These low-wealth communities span all races, ethnicities and regions of the country. As a result of scarce resources and a desire to break the problem into addressable/manageable segments, the Expanding Black Business Credit Initiative formed to make an argument to start with the Black community. We made it clear in this report that the potential investment gain for Black communities and the nation are highest because of multiple generations of oversight, under-investment and some intransigent racial perception issues. We believe that the structure and learnings from the EBBC initiative can be used for subsequent initiatives that address the problems of other low-wealth communities.

The report highlights the structure and framework of a specific investment initiative centered around a consortium of Black-led CDFIs, which has both knowledge-sharing and capital raising components. For this consortium to be successful, significant support from large banks and foundations is required. Our hope is that this report will produce the funding necessary to achieve a successful pilot of the investment proposal, but moreover will create a series of other investment consortiums that address the specific requirement of the many other low-wealth populations of the country.

APPENDIX 1

Known Data on Supply/Demand Small Business Credit to Black-Owned Businesses

The project was able to find some information about the volume of originations in the United States of small business loans of under $1 million to small businesses. The only current source that specifies the race of small business borrowers is quarterly reports on approved SBA 7a loan guarantees. There is data under the federal Community Reinvestment Act on bank small business loan originations under $1 million in low- and moderate-income census tracts, which could roughly correspond to the markets of certified CDFIs.

There is modest information about the demand for loans by Black-owned businesses nationally in the markets served by the EBBC-7. There are national estimates in recent reports by the Aspen Institute and Association for Economic Opportunity as well as thoughtful discussions in academic papers by Tim Bates and William Bradford.

It is well known that commercial banks have steadily reduced their booking of small business loans and that Community Reinvestment Act enforcement weakened after the end of the Clinton administration. The percentage of bank commercial loans outstanding of loans under $1 million at origination has declined in the long term from the mid-30% range in the 1990s to 20% of total commercial loans outstanding in recent years. The following information on origination volume in 2015 by source provides limited context for the report.

SOURCE	DATE	ORIGINATIONS	NOTES
FDIC quarterly reports on loans outstanding under $1 million, June 30, 2015	6/30/2015		$1.5 trillion in outstandings
Bank originations of commercial loans under $1 million, reported under Community Reinvestment Act (CRA)	12/31/2015	$227.8 billion	
Bank originations of commercial loans under $1 million reported under CRA in low-moderate income tracts	12/31/2015	$55.8 billion	
Online small business lenders	12/31/2015	$7.5 billion	
CDFIs reporting to Opportunity Finance Network as commercial and commercial real estate lenders (assets are 16% of CDFI Fund's estimate of all certified CDFIs)	12/31/2015	$47.6 million	Ten basis points of the volume of bank originations in low-moderate income markets and 60 basis points of online lender volume.

APPENDIX 2

ShoreBank and EBRD Small Business Investment in Russia

In the 1990s, when Russia's economy was stalled from years of central control and mismanagement, the country's economy was labeled a "basket case." Russia was generally shunned by investors. Just around the time that Boris Yeltsin became Prime Minister, Russian leaders realized the need to kick-start their economy partly to remain economically relevant, but partly because its people had languished for years in semi-poverty conditions. Market forces were virtually non-existent and the Russian economy was broken.

When government leaders decided to take action, they began by promoting programs to foster small business development. Interestingly, as part of this effort, they turned to a small community bank in Chicago for advice on how to increase entrepreneurialism, foster animal spirits and create economic growth in their economy. ShoreBank had been successfully making loans to hard-to-finance businesses in low-wealth areas of Chicago where market forces and economic dynamism were waning.

Russian leaders and the European Bank for Reconstruction and Development (EBRD) realized that the challenges of investing in Chicago's low-wealth neighborhoods were similar to the challenges of investing in Russia's moribund economy and former state-run companies. EBRD created a $10 million seed fund that was managed by ShoreBank and the funds distributed by three local Russian banks that knew their markets well and could help with loan processing, distribution and management.

ENDNOTES

[1] The size of the equity investment required is yet to be determined and will be established in Phase 2 of the project by the EBBC Steering Committee.

[2] Porter, Michael, *The Competitive Advantage of the Inner City,* Harvard Business Review, May-June 1995 Issue, p. 2.

[3] Ibid. This is particularly true for small business employer firms, which, for the purposes of this paper, we are defining as firms with five employees or more and revenues between $500,000 and $5 million.

[4] In this report, we will often use the terms wealth, net wealth and intergenerational wealth interchangeably. While net wealth is an important snapshot measure, intergenerational wealth is an even stronger indication of the durability of a community's wealth.

[5] These businesses in turn have historically been the largest driver of employment in low-wealth communities.

[6] For the purposes of this paper, "Black" and "African-American" are used interchangeably. There is a recognition that both terms imply a broad definition meant to include American-born Blacks, African-born Blacks, Afro-Caribbean Blacks, Blacks of Haitian heritage, West Indians and so on. Similarly, for this report, we will use Latino and Hispanic interchangeably, but with a full understanding of the distinctions between these two groups. If any of these labels is used in charts, their literal definition is intended.

[7] Pew Research and US Census Data (specific citations being verified)

[8] See appendix for experience of ShoreBank in the early development of Russia

[9] Returns defined in terms of impact, financial and economic

[10] Animal spirits guide the confidence, fear, and pessimism that impact the decisions that fuel or hamper economic growth. According to the theory behind animal spirits, business leaders make investment and business decisions on intuition and the behavior of other businesses, rather than analysis.

[11] Bradford, William D., The "Myth" that Black Entrepreneurship Can Reduce the Gap in Wealth Between Black and White Families. Economic Development Quarterly, Vol. 28(3), p. 254-269.

[12] Gorman, Ingrid, The Tapestry of Black Business Ownership in America, Association for Enterprise Opportunity, March 2017

[13] Klein, Joyce A., Bridging the Divide – How Business Ownership Can Help Close the Racial Wealth Gap, January 2017.

[14] U.S. Department of Commerce, 2007 and 2012 Survey of Business Owners

[15] U.S. Census, Survey of Business Owners, 2012; total jobs = number of firms plus number of employees

[16] U.S. Department of Commerce, 2012 Survey of Business Owners

[17] Robb, Alicia, *Access to Capital among Young Firms, Minority-owned Firms, Women-owned Firms and High Tech Firms,* (Washington, DC: Small Business Administration, April 2013), p. 11.

[18] Areas where the difference between Black/Hispanic and White are less than 5% were considered areas of commonality. Analysis by author.

[19] Social Investment Forum, 2012 Report on Socially Responsible Investing Trends in the United States, 2016 data from FDIC, NCUA and trade associations.

[20] Gorman, Ingrid, The Tapestry of Black Business Ownership in America, Association for Enterprise Opportunity, March 2017

[21] To protect confidentiality, only consolidated data will be shown in this report.

[22] We did not collect data from the nonprofit parent of the bank, but did collect and consolidate the data from the credit union and its parent.